# DRAFT FINDINGS
# COMMERCIAL PRACTICES WORKING GROUP

**Wednesday, May 17, 2006**

## Part I Commercial Practices by Commercial Buyers

- Commercial "Best Practices"
- Competition in the Commercial Marketplace
- Contract Terms and Conditions Used in Commercial Contracts
- Pricing of Commercial Contracts by Commercial Buyers

## Part II Commercial Practices by Government Buyers

- The Government's "Commercial" Practices
- Nature of the Government Commercial Market

## Part III Other Findings

- Time and Materials Contracts

## Part I A – Findings Related to Commercial Practices by Commercial Buyers

### Commercial "Best Practices"

*What are the best commercial practices, particularly for services acquisition, used by commercial buyers in the commercial market place?*

**Finding: Commercial "best practices" include a clear definition of requirements, reliance on competition for pricing and innovative solutions, definite preference for fixed-price contracts (as opposed to time and materials, and cost-based contracts), and use of short-term contracts.**

**Discussion:**

The panel found a number of common "best practices" among commercial buyers in the commercial market place. Commercial buyers spend the time and apply the resources necessary up front to clearly define their requirement. They use multidisciplinary teams to plan their procurements, conduct competitions, and monitor contract performance. They rely on well-defined requirements and effective competition to reduce prices and obtain innovative and high quality goods and services. Commercial buyers establish objective measures of performance and continuously monitor contract performance. They rely on carefully crafted standardized terms and conditions, developed with vendor input, to manage risk and ensure quality performance.

Commercial buyers also told the panel that they preferred fixed-priced contracts. Well-defined performance-based requirements facilitated the use of fixed-price contracts. These same buyers avoided the use cost-based contracts whenever possible. They felt that cost-based contracts were two expensive and placed too much of a burden on the company to manage.

### Competition in the Commercial Marketplace

*To what extent do commercial buyers rely on competition?*

**Finding: Commercial buyers rely extensively on competition when acquiring goods and services. Commercial buyers further facilitate competition by defining their requirements in a manner that allow services to be acquired fixed-price in most instances.**

### Contract Terms and Conditions Used in Commercial Contracts

**Finding: Commercial buyers generally require sellers to use the buyers' standard terms and conditions. This allows all offerors to compete from a common baseline. The use of standard terms and conditions streamlines the acquisition process,**

**making it easier to compare competing offers, eliminating the need to negotiate individual contract terms, and facilitating contract management.**

Discussion:

The commercial buyers who addressed the panel said that they have developed and use their own standard contracts. These standard contracts have several important advantages to the seller. They provide consistency and predictability. Sellers know what to expect. Also standard contract terms create a common baseline for evaluating offers in a competitive acquisition. Standard contracts also benefit the buyer. They streamline the acquisition process by simplifying the comparison of competing offers and by eliminating the need for negotiation of individual terms and conditions. Commercial buyers seldom grant deviations to their standard contract terms. Rather than tailoring terms for individual offerors, they instruct sellers to adjust their price to account for any risks associated with standard contract terms.

A number of the companies that addressed the panel provided sample agreements provided to panel. They typical term for a commercial contract was three to five years with some contacts as long seven years. Most commercial contracts address the following areas:

Contract term and renewal
Limitations on the seller’s right to stop work
Change process
Acceptance
Audit of invoices and charges
Extraordinary circumstances (mergers, acquisitions, reorganizations)
Cure notices and termination for breach
Intellectual property (ownership of works created during performance and license rights in such works)
Warranties
Remedies for breach
Limitation of liability (direct damages, indirect damages, maximum liability)
Indemnification
Insurance
Disputes
Choice of law

In addition, buyers also have developed terms and conditions specific to each seller’s industry. For example, commercial contracts for information technology services frequently contain provisions specific to that industry that pin down both price and performance risk. The buyer attempts to motivate the seller by using financial incentives or penalties linked to a combination of objective and subjective factors. Information technology service contracts often contain benchmarking provisions that provide for a downward adjustment to price if prices for a particular service declined in the industry.

There is a frequent misconception mostly in government that industry standard contracts or terms exist that can be used in agreements with the government. While contracts typically address many of the items listed above, the treatment of those items varies from contract to contract. The relative bargaining position of the parties ultimately determines what terms will be incorporated into a contract. Large commercial buyers use their relative market strength to protect their interests contractually. At the same time, if they desire competition they are careful not to mandate onerous terms that limit competition.

***Pricing of Commercial Contracts by Commercial Buyers***

**Findings: Commercial buyers generally require sellers to use the buyers' standard terms and conditions. This allows all offerors to compete from a common baseline. The use of standard terms and conditions streamlines the acquisition process, making it easier to compare competing offers, eliminating the need to negotiate individual contract terms, and facilitating contract management.**

**Part I B – Discussion of Commercial Practices by Commercial Buyers**

I. How Do Commercial Buyers Plan For and State Their Requirements?

Commercial organizations use dedicated teams of highly skilled, highly trained employees and outside consultants to manage services acquisition. These employees and consultants often hold Masters of Business Administration ("MBA") degrees from top business schools, or maintain deep experience facilitating services transactions.[1]

A. Defining Requirements

> *The success of [a services acquisition] arrangement depends on work done before the contract, and hardly ever what's in the contract.*[2]

1. Effective services competition in the private sector rests upon a robust requirements-building process.[3]

Requirements' gathering is a fundamental first step in commercial organizations' services acquisition strategy.[4] Companies with deep experience in services acquisition rate acquisition process governance as highly as selecting the provider with the best

[1] Testimony of N. Hassett, United Technology Corporation, March 30, 2005, p. 109.
[2] Testimony of R. Zahler, Shaw Pittman, April 19, 2005, p. 14.
[3] Testimony of J. Menker, Concurrent Technology Corporation, May 17, 2005, p. 32 (culture change to focus on requirements definition is difficult, but the best written contract cannot fix poor requirements definition).
[4] Testimony of M. Stelzner, EquaTerra, August 18, 2005, p. 360.

functional expertise.[5] For buyers, comprehensive Statements of Work communicating contract requirements and expected levels of service quality are essential to a successful relationship with vendors.[6]

Private sector companies spend significant time and resources developing business cases for services acquisition.[7] Cost reduction is just one component of the business cases. Research has shown that too much focus on cost reduction led many commercial organizations to miss opportunities and, in some cases, caused eroded service quality in other areas of the organization.[8] Stated differently, total cost of service acquisition does not equal total value captured through sourcing.[9] Companies that conducted successful sourcing transactions focused on total value when planning requirements, and created statements of work with well-defined scopes of desired services.[10]

### 2. Requirements Building Tools

#### a. Requests for Information (RFIs)

Commercial organizations use RFIs to gather information about the marketplace and vendor capabilities.[11] One company, for example, testified that it issues RFIs widely to learn about potential bidders. That company sends full requests for proposals ("RFPs") to four vendors chosen from RFI respondents.[12] Similarly, commercial organizations use focus groups as part of the requirements-setting process. RFIs and focus groups are useful tools to learn about potential vendors, as well as to decide whether to conduct an acquisition at all.[13]

#### b. Dedicated Internal Teams Define Deliverables and Performance Measures

Internal teams of MBAs, CPAs, or other experienced professionals manage services acquisition at a number of leading commercial organizations.[14] Dedicated teams allow continuity along the acquisition process. Communication and clear management of service providers is essential to a successful service acquisition transaction.[15] As such, commercial organizations derive significant benefit from using the same individuals for all issues, and working from the same standard documents across the services acquisition

[5] *Id.*
[6] Testimony of R. Miller, Proctor & Gamble, March 30, 2005, p. 80.
[7] Testimony of T. Furniss, Everest Group, March 30, 2005, p. 122.
[8] *Id.* at 121; Testimony of T. Scott, The Walt Disney Company, April 21, 2006, p. 11.
[9] Furniss, p. 116.
[10] Testimony of R. Casbon, Bayer, August 18, 2005, p. 218; Zahler, p. 16.
[11] Hassett, p. 108.
[12] *Id.*
[13] Stelzner, p. 353.
[14] *See* Hassett, p. 109, 136.
[15] *See* notes 3 – 10, *supra*, and accompanying text concerning the important of setting, and communicating, requirements.

process.[16] Best practice research shows that dedicated teams are more likely to focus on important issues such as aligning the vendor's interests with the purchaser's, and avoid communicating fragmented messages to vendors.[17]

c. Firm Internal Agreement By All Stakeholders on Business Requirements and Service Levels

When selecting contracting parties, commercial organizations conduct extensive internal due diligence. For example, some commercial entities endeavor to understand current costs of services, then determine how to improve upon cost while maintaining quality or making improvements in other desired areas.[18] Other commercial entities secure internal consensus by putting the objectives of service acquisitions in writing and circulating the page internally. The document serves as the basis for discussions about the requirements.[19]

B. Planning Process

> *A product you can specify in detail. A service you should specify at a higher level of abstraction and get technical solutions back from the suppliers . . . .*[20]

1. Commercial Requirements Building Process Is Usually Completed In Four To Six Months, Or Less

Commercial entities that succeeded with large-scale services acquisition invested substantial time in defining service requirements and expected outcomes. Companies welcomed vendor input during the requirements definition process. Consultants recommend working closely with contractors to define needs and align interests and objectives.[21] Best practice research indicates communication with vendors should not all be in writing. Face-to-face meetings are most successful to align objectives and allow contractors the chance to absorb all aspects of the proposed relationship.[22] In person communication is essential because that type of information is "not going to ever find its way into a document."[23]

2. (Commercial Buyers Use Multidisciplinary Staff To Monitor Performance and Manage Contract)

3. Consultants With Deep Credentials And Experience Frequently Used By Commercial Firms in Building Requirements

16 Zahler, p. 31.
17 *See* Zahler, p. 75 (discussing consequences of not aligning message at all levels of purchaser's organization).
18 Miller, p. 78.
19 Zahler, p. 35.
20 Zahler, p. 25.
21 Furniss, p. 127.
22 *Id.* at 127.
23 *Id.* at 135.

Buyers in the commercial environment frequently hire experienced consultants and attorneys to assist sourcing transactions.[24]

#### 4. Consultants Prohibited From Bidding Or Participating In Any Way In The Acquisition

## C. Defining Contract Requirements

#### 1. Commercial Buyers Define Content Of Requirements By The Outcome Of the Work

While commercial buyers often provide vendors with detailed Statements of Work explaining requirements, expected levels of quality, and other metrics, the Statements of Work do not specify how to perform the work.[25] Commercial buyers use RFPs to define desired outcomes, and ask vendors to propose processes for achieving the outcomes.[26] The process allows suppliers to separate based on their individual capabilities.[27] Commercial buyers have found that providing detailed RFPs spelling out all services and processes for performance does not allow vendors to propose optimal solutions. "All that produces is the lowest common denominator of a solution."[28] According to one sourcing consultant, the standard government model of writing detailed RFPs results in a transaction, not a relationship, and can hinder long-term success of a services acquisition effort.[29] By focusing the RFP on outcomes, contractors are more likely to focus their proposal efforts on finding more efficient ways to get the job done.[30]

#### 2. Successful Commercial Organizations Do Not Procure Services Unless They Understand Their Requirements, Goals, and Rationale

Consultants and attorneys advising commercial entities have found vendor relationships more likely to fail when companies do not fully understand the requirements and reasons for the transaction.[31] Acquisitions designed solely to decrease price typically fail to deliver expected quality levels. Stated differently, price is a necessary component of a transaction, but is not a sufficient reason to conduct the transaction.[32]

### 3. Vendors Are Responsible For Proposing How To Accomplish Objectives

Commercial organizations issue RFPs designed to focus vendors on their capabilities and commitments to unique solutions, separating quickly the most promising

[24] *See* testimony of Furniss, Zahler, Bajaj.
[25] Miller, p. 80.
[26] Furniss, p. 137; Zahler, p. 28.
[27] Zahler, p. 24.
[28] Zahler, p. 51.
[29] Testimony of P. Allen, Technology Partners International, April 9, 2005, p. 160.
[30] Testimony of R. Ayers, SAIC, July 27, 2005, p. 275.
[31] *See* Furniss, p. 124 (advises clients to explore desired feature, function, and benefit-level improvements); Zahler, p. 16 (value to the company is the most important issue to discuss, and value is more than just price).
[32] Zahler, p. 38; Scott, p. 11 (discussion of relative importance of speed, value, and price).

vendors for further discussion.[33] Companies invite suppliers' suggestions based on experience or proprietary solutions, facilitating selection among several customized solutions.[34]

## II. How Do Commercial Buyers Use Competition?

### A. Head-To-Head Competition Preferred

Successful commercial organizations do not make frequent use of sole-source, or other contract forms that restrict competition. A company that addressed the panel, for example, sends RFPs to four leading vendors and holds discussions with at least two of the four.[35] Consultants and attorneys recommend maintaining competition throughout the procurement process.[36]

### B. Use of Fixed Price Contracts

Larger commercial organizations use fixed price contracts in preference to time and materials contracts. Consultants indicate the most effective contract type is firm fixed prices.[37] A large automotive company, for example, uses only firm fixed price contracts for information technology services acquisition.[38] The rationale is, if the company defines its requirements upfront, then asks vendors to price the requirements, then vendors bear this risk of price variances.[39]

### C. Always Have Two or Three Vendors Competing

While commercial organizations down select from multiple potential offerors very quickly, negotiating with more than one vendor at a time produces more favorable outcomes than sole-sourcing. For example, a major aerospace company down selects to two vendors early on, then conducts full negotiations with the two.[40] Competition is essential to successful outcomes:

> Long-term cost of the service is a function of many factors other than day-one price – almost all of which will be adverse to the customer, if there's no competition.[41]

By down selecting to two or three vendors early, commercial organizations are able to conduct detailed discussions and negotiations with each. As vendors learn more about the customer, vendors are able to tailor services more specifically to the customer's

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[33] *See* Zahler, p. 69;
[34] *See* notes 28 - 28, *supra*, and accompanying text.
[35] Miller, p. 79.
[36] *See* Furniss, p. 142; Zahler, p. 55.
[37] Testimony of B. Bajaj, TPI, August 18, 2005, p. 131.
[38] Testimony of M. Bridges, General Motors, August 18, 2005, p. 136.
[39] *Id.* at 137.
[40] Hassett, p. 110.
[41] Zahler, p. 48.

needs.[42] The discussions process is time-intensive, and takes significantly longer with each additional bidder. Leading commercial companies, therefore, limit full negotiations to two or three vendors.

D. Retain Right In Contract Terms to Compete New Requirements Or Take Them In-House

In addition to maintaining the right to terminate for convenience and default in services contracts, a one company that markets consumer products world-wide retains the right to use another vendor for new technology requirements, or to bring the work in-house.[43] Other companies also retain rights to terminate, in-source, and re-source.[44] Commercial companies view the right to re-source to other vendors, or bring the work in-house, as essential to maintain vendor quality as well as allow enough flexibility to effectively manage change.[45]

E. Recompete "Technology Heavy" Contracts Every Three to Five Years

III. How Do Commercial Buyers Conduct Competition?

A. Precompetition

1. Detailed Market Research Performed Regarding Vendor Capabilities

Commercial organizations need to be comfortable the vendors under consideration are capable of providing desired services.[46] To that end, companies regularly use sourcing consultants with ready access to vendor pricing and capability information.[47]

2. Provide Extensive Opportunities for Buyer/Supplier Interchange Of Information About the Buyer's Needs and Operations Before Submission of Proposals

Consultants state that, if buyers and suppliers are able to align their business objectives and expectations for sourcing relationships, the rate of litigation or termination is less than one percent.[48] Every interaction between buyer and supplier represents an opportunity to exchange information. Successful commercial companies use these opportunities to their advantage.[49] For example, a major entertainment company conducts extensive pre-competition communication with its base of vendors.[50] After determining a high correlation existed between success of service acquisition initiatives

[42] Zahler, p. 55.
[43] Miller, p. 82.
[44] Hassett, p. 123.
[45] *See* Allen, p. 153 (every outsourcing contract has at least one material change over the course of the contract; organizations must be ready to manage the dynamic nature of services acquisition.)
[46] Miller, p. 78.
[47] *See* testimony of Bajaj; Allen.
[48] Allen, p. 148.
[49] Zahler, p. 75.
[50] *See* Scott, pp. 8-15.

and the vendor's knowledge of that company's business, senior executives began presenting the company's goals and objectives to vendors at large luncheons every six months.[51] At these luncheons, existing vendors also receive report cards grading their existing efforts and providing feedback on successful and unsuccessful practices.[52] The report cards offer vendors the chance to improve their performance before the next competition occurs. The result was a significant increase in quality.[53]

## B. Solicitation

### 1. Standard Commercial Contract Terms For Buyer

Companies found that negotiating anything other than standard commercial terms rarely drove additional benefit to the corporation and took time and resources that could have been deployed elsewhere.[54] Standard commercial contract terms allow purchasers to save procurement time, especially when vendors must pre-agree to the terms before competing for contracts.[55]

### 2. Balanced Contract Terms Developed Through Interaction With Vendors

Buyer/Vendor relations are more likely to fail if the supplier and the purchaser are not aligned around the same business objectives.[56] Consultants recommend suppliers understand vendor pricing and profit. The vendor should earn a reasonable profit for work performed. Earning less is more likely to result in negative outcomes.[57] Commercial organizations ask about vendors' critical assumptions driving profits.[58] The information allows purchasers to perform a reality check of the assumptions and avoid surprises during contract performance.[59]

#### 3. No Variance In Contract Terms Except In Extraordinary Cases For Limited Reasons

Best practice research indicates using detailed terms sheets describing all aspects of deals in plain, simple, business-person's language prevents misunderstandings about performance requirements and obligations.[60] Aggressive schedules with achievable dates are also important factors of successful sourcing transactions.[61] The requirements and schedule exist for a reason. Commercial organizations rarely permit adjusting contract terms. Stated differently, "you should die before you slip the schedule."[62]

[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] Scott, p. 18.
[55] *Id.*
[56] Allen, p. 155.
[57] *Id.* at p. 155, 165.
[58] *Id.* at 165.
[59] *Id.*
[60] Zahler, p. 49.
[61] *Id.*
[62] *Id.* at 74.

4. If Vendor Perceives Risk, Vendor Must "Price It"

Commercial companies value predictability in service delivery. There should be no surprises.[63] Companies expect to pay for everything, but only once.[64] Contractors have the task of adequately pricing risk.[65]

C. During Competition

1. Commercial Practice Involves Extensive Negotiations With Vendors In The Competition Regarding Vendor-Specific Solutions

Commercial companies frequently allow apples-to-oranges service comparisons.[66] Vendors are permitted to capitalize on their respective strengths, experience, and proprietary solutions to offer the best possible solution.

2. Early Narrowing Of The Competitive Range

Streamlined RFPs focusing on objectives, specifications and requirements provide commercial companies enough information to permit early downselection.[67] Negotiations with each surviving vendor takes significant time and resources, with each additional vendor making the process exponentially longer.[68] Commercial companies regularly downselect to two or three vendors and then conduct full negotiations.

[63] Allen, p. 165.
[64] *Id.*, p. 182.
[65] Bridges, p. 137.
[66] *See* notes 25 - 30, *supra* and accompanying text.
[67] *Id.*
[68] Zahler, p. 70.

## Part II A – Findings Related to Commercial Practices by the Government

***The Government's "Commercial" Practices***

**Finding: The government has adopted various competitive procedures in buying commercial items and commercial services in an attempt to mirror the commercial marketplace. These procedures facilitate procurements with a constrained acquisition workforce but do not always achieve the same benefits that commercial buyers achieve in the commercial marketplace.**

**Discussion:**

*[To be provided]*

***Nature of the Government Commercial Market***

**Finding: The government market for commercial goods and services does not always reflect the commercial marketplace. In noncompetitive awards, the government does not always benefit from commercial market forces.**

**Discussion:**

*[To be provided]*

## Part II B – Discussion of Commercial Practices by the Government

**Discussion:**

*[To be provided]*

## Part III A – Other Findings

### *Time and Materials Contracts*

**<u>Finding</u>: Commercial buyers avoid the use of time and materials contracts if possible. The federal government makes extensive [*to be quantified*] use of time and materials contracts.**

**<u>Discussion</u>:**

*[To be provided]*

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## Part III B – Discussion of Other Findings

**<u>Discussion</u>:**

*[To be provided]*